BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
AMERICAN AIRLINES, INC.)

Appearances:

For Appellant: P. G. Larie and T. 0. English, Assistant Treasurers of Appellant

For Respondent: Burl D. Lack, Chief Counsel; Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 25667 of the Revenue and Taxation Code (formerly Section 19 of the Corporation Income Tax Act and Section 25 of the Bank and Corporation Franchise Tax Act) from the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protests of American Airlines, Inc., with respect to proposed assessments of additional corporation income tax in the amount of $4,024.09 and franchise tax in the amount of $4,392.82 for the income years 1942 and 1943, respectively. Certain of the adjustments made in the proposed assessments for these years have been conceded by Appellant and are not questioned herein.

The first issue presented is whether the gain from the sale of aircraft and equipment to the United States Government in 1942 comes within the nonrecognition provisions of Section 11(f) of the Corporation Income Tax Act as a gain upon an involuntary conversion.

Appellant, a Delaware corporation, operated an airline in California and other states during the years involved herein. In early 1942, under a directive issued by the President of the United States, the War Department took steps to commandeer from domestic airlines in this country all transport aircraft in excess

of a certain number. Nineteen planes and equipment owned by Appellant were requisitioned by and sold to the Government at a gain of $1 094,651.89. The sales were made between March 14 and May 29, 1942. Because existing war conditions prevented the immediate acquisition of replacement planes Appellant decided to establish a replacement fund and proceeds of the sales were deposited in a special deposit account for that purpose, Due to economic circumstances this plan was later abandoned and Appellant reported its gain for federal income tax purposes for the year 1942. After June, 1943, the funds received upon sale of the planes in 1942 were used for general company purposes. As soon as it became possible to acquire planes from the Government through the War Assets Corporation, Appellant did so. The first purchases were-made in October, 1944; in all 66 planes were purchased by Appellant during 1944, 1945 and 1946.

During the year 1942, Section 11(f) of the Corporation Income Tax Act was, in all respects material here, similar to Section 112(f) of the Internal Revenue Code, and provided as follows:

> "If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the commissioner, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.'?

Appellant contends that its gain should not be recognized under Section 11(f) because it forthwith in good faith used the proceeds from the requisitioned planes to

acquire replacement aircraft. The Franchise Tax Board, on the other hand, argues that the money received upon the involuntary conversion of the planes was not expended for the acquisition of replacement planes as the money was not traceable to such purchases.

In Frischkorn Development Company, 30 B.T.A. 8, affirmed in 88 Fed. 2d 1009, the Board of Tax Appeals held that to come within Section 203(b)(5) of the Revenue Act of 1924 (predecessor of Section 112(f) of the Internal Revenue Code) the taxpayer must trace the money received into the payments for the property purchased. The Board stated that this construction is clearly indicated by the provision of the last sentence of the Section that if any part of the money is not expended for replacement, gain shall be recognized to an amount not in excess of the money not so expended. The Board concluded, accordingly that the taxpayer may not spend the money for a general purpose, use other money for the purchase of like property and still receive the benefits of the Section. Following this decision the requirement of tracing the proceeds was set forth in the Federal Regulations 86, Article 112(f)-1 issued in 1935 (now in Regulations 111, Section 29.112(f)-1), and has been consistently upheld by subsequent decisions, Kennebec Box & Lumber Co., Inc. v. Commissioner, 1.68 Fed. 2d 646, Ovider Realty Company v. Commissioner, 193 Fed. 2d 266, and Continental Realty Company, T.C. Dec., Docket No. 80, entered January 17, 1944.

There were no California regulations on Section 11(f) in 1942. Regulation 25035(a) (Title 18, California Administrative Code, Section 25035(a)), adopted in 1952, is substantially the same as Section 29.112(f)-1, Federal Regulation 111, and provides in part that to avail itself of the non-recognition provisions of Section 25035 of the Revenue and Taxation Code (formerly Section 11(f) of the Corporation Income Tax Act) "it is not sufficient for the taxpayer tc show that subsequent to the receipt of money from a condemnation award it purchased other property similar or related in use. The taxpayer must trace the proceeds of the award into the payments for the property so purchased." Prior to the adoption of Regulation 25035(a) the Federal Regulation above cited had been followed by Respondent as its administrative practice.

Appellant contends that in the absence of a California regulation on Section 11(f) the Federal Regulation on Section 112(f) of the Internal Revenue Code, requiring the tracing of proceeds, is not authority for such a requirement in the California law. This argument overlooks the fact that the tracing requirement

originated in a judicial decision, i.e., Frischkorn Devclopnent Company, supra, construing the identical language of Section 112(f) and was added to the Federal Regulations after that decision. The Frischkorn case was decided prior to the enactment of Section 11(f) of the Corporation Income Tax Act. Since the provisions of Section 11(f) were copied from the Federal statute it is presumed that our Legislnture intended to adopt the construction as well as the language of the Federal statute. Holmes v. McColgan, 17 Cal. 2d 426; Union Oil Associates v. Johnson, 2 Cal. 2d 727; Meanley v. McColgan, 49 Cal. App. 2d 313.

The money received upon the involuntary conversion of planes in 1942 was admittedly used for general purposes in 1943. Such money, accordingly, was not expended for replacement planes acquired in 1944, 1945 and 1946, and it is unnecessary to consider other requirements of the statute. The gain arose from the sale of business assets and was properly included in Appellant's income subject to allocation.

The second issue involved in this appeal is whether the Commissioner was correct in apportioning the value of Appellant's flight equipment within and without California upon the basis of revenue miles flown within the State to total revenue miles flown for tho purpose of determining the property factor of the allocation formula for 1942 and 1943.

To determine the portion of Appellant's not income dcrived from sources within California for the income years 1942 and 1943, allocation was made by using the three-factor formula of property, payroll and sales. Apportion of Appellant's tangible personal property consisted of flight equipment which was used both within and without California,, Appellant, for purposes of the property factor of the allocation formula for 1942 and 1943, apportioned the entire value of its flight equipment without California, The Commissioner, however, assigned some of the flight equipment to this State upon the revenue miles basis. The percentage of revenue miles flown in California to total revenue miles was 4.0594 for 1942 and 5.714 for 1943. For the income year 1942, the inclusion of the portion of the flight equipment increased the California property factor from 1.2211% to 2.6508% and increased the percentage of total net income allocated to California from 4.6056 to 5.082. For the income year 1943, the inclusion of the portion of the flight equipment increaseti tha property factor from 1.4633%

to 2.7127% and increased the percentage of total net income allocated to California from 5.2270 to 5.6435. The pay of flying personnel, for purposes of the payroll factor, was also apportioned upon a revenue miles basis.

The Appellant opposes the Commissioner's action in this regard by contending that it would be more equitable to apportion the value of flight equipment upon the basis of the number of arrivals and departures within the State to total arrivals and 'departures everywhere. The ratio of California arrivals and departures to total arrivals and departures was 2.6969% for 1942 and 3.5294% for 1943. Appellant also contends that it is unfair for the Commissioner to use a revenue miles percentage against flight equipment for purposes of the property factor as well as against flight pay for purposes of the payroll factor "since the taxpayer is not given an opportunity of utilizing all necessary variables that reflect its activity in the State." In our opinion, the Appellant's contentions do not support a reversal of the Commissioner's action on this issue.

Section 13 of the Corporation Income Tax Act in 1942 read as follows:

> "In the case of corporations owning property or engaging in business or activities both within and without the State, the net income derived from sources within this State shall be determined by an allocation upon the basis of sales, purchases, expenses of manufacture, payroll, value and situs of tangible property or by reference to any of these or othur factors or by such other method of allocation as is fairly calculated to determine the net income from sources within this State . .."

Section 10 of the Bank and Corporation Franchise Tax Act, in all respects material here, was identical in 1943 to Section 13. The construction given the language of one is, therefore, applicable to the other. These Sections gave the Commissioner considerable discretionary power to determine the formula or method of allocation to carry out the purpose of the statutes to achieve a proper apportionment of business done within and without the State. El Dorado Oil Works v. McColgan, 34 Cal. 2d 731; Pacific Fruit Express Co. v. McColgan., 67 Cal. App. 2d 93. "One who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed." Butler Brothers v. McColgan,

315 U. S. 501, 507; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472. In this case Appellant has presented no evidence showing that the Commissioner's apportionment of the value of flight equipment within and without California upon the percentage of revenue miles flown resulted in the taxation of income attributable to sources outside this State. It has been the long-standing practice of the Commissioner and of the Franchise Tax Board to apportion moveable flight equipment upon a revenue mile basis. The use by the Commissioner of car mileage as the basis for determining the amount of a railway refrigerator car company's rolling stock within and without the State for the purposes of the property factor in the apportionment formula received judicial approval in Pacific Fruit Express Co. v. McColgan, supra. In that case car mileage was also used as one of the factors in the three-factor formula (property, payroll and mileage). We conclude that Appellant has not met its burden of proof on this issue, and accordingly that the Commissioner's method of allocation must be sustained.

A final issue involves the question whether the Commissioner correctly included in Appellant's allocable income interest which was received by Appellant in 1943 on United States Treasury Notes, Series C.

Appellant invested funds in United States Treasury Notes of Tax Series C. In 1943 it received interest on these notes in the amount of $35,278.98. Treasury Notes of Tax Series C mature three years after the date of issuance. During and after the second calendar month following the month of issuance the notes are receivable, at par and accrued interest, by the collector of internal revenue in payment of any Federal income, estate or gift taxes assessed against the original owner or his estate. If not presented in payment of taxes the notes are paid at maturity, or at the option and request of the owner may be redeemed before maturity during or after the sixth calendar month following the month of issuance. See Department Circular 696, CB 1942-2, p. 171.

Appellant corporation is not domiciled in California. As respects such a corporation the Franchise Tax Board concedes that interest received from sources not connected with the corporation's business is not subject to allocation. The narrow question for decision, therefore, is whether the securities in question constituted an integral part of the corporation's unitary business, or an investment separate

and apart from that business.

Because the treasury notes could be, and were, used for payment of federal taxes substantially all of which were imposed because of income from Appellant's airline operations, the Franchise Tax Board contends that interest derived from the investment in such notes should be considered as connected with the corporation's unitary business, as is interest on other working capital employed in that business.

The Appeal of Marcus Lesoinc, Inc., decided July 7, 1942, cited by the Franchise Tax Board, does not support its position here. In that matter we held that interest derived from conditional sales contracts was subject to allocation. The conditional sales contracts, however, resulted directly from the selling activities of the corporation and the management and liquidation, as well as the acquisition, of the contracts were carried on as integral parts of the corporation's regular business operations. Such is not the situation here. The source of the interest received by Appellant was its investment in government securities and not the operation of its airline business, or a related activity. In view of these considerations we conclude that the tax notes were not an integral part of Appellant's unitary business and that the interest derived therefrom was not subject to allocation.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED pursuant to Section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Commissioner (now succeeded by the Franchise Tax Board) on the protests of American Airlines, Inc., with respect to proposed assessments of additional corporation income tax in the amount of $4,024.09 and franchise tax in the amount of $4,392.82 for the income years 1942 and 1943, respectively, be and the same is hereby modified as follows: The Commissioner's action in overruling

Appellant's protest against the proposed assessment of the amount of additional tax attributable to the inclusion of the sum of $35,278.98 in Appellant's allocable income for the income year 1943 is hereby reversed; in all other respects the action of the Commissioner is hereby sustained.

Done at Sacramento, California, this 18th day of December, 1952, by the State Board of Equalization.

Wm. G. Bonelli, Chairman

J. H. Quinn, Member

Geo. R. Reilly, Member

_____, Member

_____, Member

ATTEST: F. S. Wahrhaftig, Acting Secretary